

IntriCon 2017 First-Quarter Results

Moderator: Scott Longval
April 25, 2017
4:00 pm CT

Operator: Good day everyone and welcome to the IntriCon first quarter 2017 results conference call. At this time, all participants are in a listen-only mode. Later, you will have the opportunity to ask questions during the question and answer session.

You may register to ask a question at any time by pressing the star and 1 on your touch-tone telephone keypad. Please note that this call may be recorded and I will be standing by should you need any assistance.

It is now my pleasure to turn the conference over to you chief financial officer, Scott Longval. Please go ahead, sir.

Scott Longval: Thank you, operator. Joining me on today's call is Mark Gorder, IntriCon's CEO but before we begin, I'd like to preface our remarks with the customary Safe Harbor statement.

Today's call contains certain forward-looking statements. These statements are based on current estimates and assumptions of Intercon's management and are subject to uncertainty and changes in the circumstances.

Given these uncertainties, you should not place undue reliance on these forward-looking statements. Actual results may vary materially from the expectations contained in today's call.

Important factors that could cause such differences include, among others, those set forth under the headings risk factors and management's discussion and analysis of financial condition and results of operations in our 10K filing for the year ended December 31, 2016. With that, I'd now like to introduce Mark for a strategic look at IntriCon's first quarter.

Mark Gorder: Thank you, Scott, and thank you, everyone, for joining us today. I would like to begin by reviewing key highlights and results for the first quarter. After that, Scott will cover the financials in more detail and then we'll take your questions.

By this time most of you have had a chance to review our first quarter press release. For the quarter, the company reported record net sales of \$20.1 million compared to \$18.1 million in the prior year period.

The increase was primarily due to year-over-year revenue gains from IntriCon's largest medical customer and included a \$1.4 million contribution from Hearing Help Express, or HHE.

Net sales rose 13% sequentially from the 2016 fourth quarter. Looking at our three businesses, our medical business sales increase 19% in the 2017 first quarter chiefly driven by our largest customer, Medtronic.

The gain was due to the expected production ramp up of Medtronic's MiniMed 630G wireless glucose monitoring system. Higher first quarter production also resulted in a \$1.9 million sequential increase in Medtronic revenue for the 2016 fourth quarter.

Short term, we remain well-positioned with Medtronic with 2017 second quarter sales also expected to be at record levels and growth anticipated to continue throughout the second half of the year.

Longer term, the future also looks favorable with Medtronic. In addition to the MiniMed 630G system, IntriCon has also designed into the MiniMed 670G system, the world's first hybrid closed loop insulin delivery system which was also recently approved by the FDA. It is scheduled to be launched in the spring of 2017.

Turning to Hearing Help, sales in Hearing Help grew 9% from the prior year first quarter primarily stemming from a \$1.4 million contribution from HHE. As previously announced, we acquired a 20% stake into (Cal) Illinois-based HHE, a direct to consumer mail order hearing aid provider in the fourth quarter of 2016.

In January 2017, we announced that we had exercised our option to acquire the remaining 80% stake in HHE. The deal is expected to close in the second half of the year.

Since taking our initial stake in HHE, we've made substantial progress integrating and optimizing the organization. Year-to-date, we have completed the relocation of the business which is expected to drive operating efficiencies and better work management by merging two locations into one.

Enhanced HHE sales and marketing capabilities and increased advertising spend and introduced our first advanced digital hearing device, the EarMate-4220, into HHE's portfolio.

While we are new to this business and still determining the most critical lead measures, we have identified two that we believe demonstrate progress is being made.

HHE's order backlog increased 20% from Q4 2016 to Q1 2017 driven by targeted advertising and follow up care. And we identified three new - 3000 new leads during Q1 through focused lead generation advertising initiatives.

As we identify other applicable lead measures, we intend to refine the metrics we report on in the future to provide greater visibility on our progress. Along with the addition of HHE, I'm excited to announce that IntriCon has entered into an agreement to acquire a 49% stake in Soundperience.

Soundperience has designed state-of-the-art self-fitting hearing aid technology. Soundperience software applications are the first cycle acoustic way of analyzing peripheral hearing and central hearing processing.

The company's self-fitting hearing aid technology is being used in the German market today most notably through our previously disclosed (Signasound) joint venture with Soundperience.

Currently the technology is PC-based and is wired to the hearing aid during programming. However, the system will be integrated with Intercon's wireless hearing aids over the next few months and initially rolled out in Germany through our (Signasound) joint venture.

We believe strongly that incorporating self-fitting technology is a critical step in creating our high quality, low cost hearing health care ecosystem. Soundperience's technology has the potential to drastically reduce the price of hearing aids, drive greater access and increase customer satisfaction.

We anticipate piloting a version of the cloud-based system with our wireless hearing aids in the US market by Hearing Help Express in the 2017 third quarter.

At the conclusion of our annual shareholder's meeting this Thursday, we will be giving a short demonstration of the self-fitting software. HHE and Soundperience give IntriCon direct access to consumers and the emerging value-based hearing health care market and the ability to self-fit hearing aids.

We believe that the combination will drive a lower priced alternative for consumers to purchase devices directly and successfully manage their own care experience circumventing layers of cost associated with the conventional hearing aid channel.

Looking at some of the other hearing health initiatives, we also saw contributions from PC Worth during the quarter. In January 2017, we took steps to reduce PC Worth's cost structure by \$200,000 and refocused sales efforts into the National Health Service Clinics.

Just yesterday, we received formal approval from the NHS for a third device, the Kamplex 940D, which will enhance IntriCon's sales opportunities. The Kamplex 940D, which is a traditional behind-the-ear device, is very appealing to the NHS because of its broad fitting range and advanced features.

During the next quarter, we will launch our sales efforts for the Kamplex 940D as well as the previously approved Kamplex KITE device. We have identified 12 initial NHS reference sites that are willing to distribute non-Big 6 hearing products.

They fit at least 300 hearing aids per month and they're ripe and ready to try something different. We intend to place a qualified IntriCon employee in those NHS clinics to support the clinic's fittings to patients where we will gather initial feedback.

Once the initial 12 clinics have been engaged, we will reach and attract and convert further NHS sites using the initial reference sites. Our goal is to be delivering 1000 hearing aids a month to the NHS by the end of 2017.

Shifting now to public policy. There have been significant developments during the first quarter. Legislation was introduced in the House and Senate to make hearing aids available over-the-counter for those with mild to moderate hearing loss.

Should it pass, this legislation has substantial implications for IntriCon and the entire value of hearing health industry. The proposed legislation would require the FDA to write regulations, ensuring that this new category of over-the-counter hearing aids meets the same high standards for safety, consumer labeling and manufacturing protections as all medical devices, providing consumers the option of an FDA-regulated device at lower cost.

The Over-the-Counter Hearing Aid Act of 2017 has the potential to remove the significant barriers existing today that prevent innovative hearing health solutions.

We believe that this legislation would invigorate competition, spur innovation and facilitate the development of an ecosystem of hearing health care that provides affordable and accessible solutions to millions of unserved or underserved Americans.

Additionally, these public policy changes all further support our strategic focus to gain direct access to the consumers and the unserved market. Now I'd like to turn the call back over to Scott.

Scott Longval: Thank you, Mark. I'll begin by reviewing our first quarter financial results in more detail.

For the 2017 first quarter, we reported record net sales of \$20.1 million compared to \$18.1 million for the prior year period.

The increase was primarily due to year-over-year revenue gains from IntriCon's largest medical customer and included a \$1.4 million contribution from Hearing Help Express. Net sales rose 13% sequentially from the 2016 fourth quarter.

IntriCon posted a net loss attributable to shareholders of \$428,000 or 6 cents per 6 cents per diluted share versus net income attributable to shareholders of \$15,000 or 0 cents per diluted share for the 2016 first quarter.

The 2017 first quarter loss included a loss from discontinued operations of \$277,000 or 4 cents per diluted share related to the divestiture of our CDM business.

It also included non-recurring acquisition and redundancy expenses of approximately \$211,000 or 3 cents per diluted share. As we've talked about previously, we've made the strategic decision to divest our non-core CDM business in order to focus financial and operational resources on value hearing health and growing the direct-to-consumer opportunity. We found a buyer for the business and the sale closed in the 2017 first quarter.

Our pro forma basis, after adding back losses from discontinued operations, costs associated with the HHE and Soundperience acquisitions and non-recurring redundancy costs in the UK, the company generated \$60,000 in pro forma net income for the quarter. You can find a reconciliation of GAAP-based net loss to adjusted net income in today's press release.

Gross profit margins were 28.3%, essentially flat with 28.2% in the prior year first quarter. Operating expenses for the first quarter were \$6 million compared to \$4.6 million in the prior year first quarter. The increase was largely due to the inclusion of HHE in 2017.

In terms of guidance, based on the information that's currently available, we anticipate the 2017 second quarter net sales to be - to range between \$20 million and \$20.4 million, and positive EPS from continuing operations.

For the year, we anticipate revenue to range between \$79 million and \$81 million. Turning to the Soundperience transaction, let me reiterate the terms outlined in that press release.

Terms of the transaction include IntriCon immediately acquiring 17% stake, followed by an additional 32% stake in the 2017 fourth quarter. As part of the initial investment, we will receive

an irrevocable worldwide license which is exclusive in the United States. Now I'd like to turn the call back over to the operator so we can take your questions.

Operator: At this time, if you'd like to ask a question, please press the star and one on your touch-tone telephone keypad. You may withdraw your question at any time by pressing the pound key. Once again, to ask a question today, please press the star and one on your touch-tone telephone keypad.

And we'll take our first question from Dick Ryan with Dougherty. Please go ahead. Your line is open.

Dick Ryan: Thank you. Say, Mark, I'm not sure I caught your full comments on Medtronic. Obviously, a strong quarter with their new products, but did you say you expect year-over-year growth across each of the remaining quarters for this year?

Mark Gorder: Yes, we did.

Dick Ryan: Okay. Okay. And when does the 670 get introduced?

Mark Gorder: It's - they have said in their press release, spring of 2017, which I think could be as early as May, but it could be late May, first part of June.

Dick Ryan: Okay. Turning to HHE, \$1.4 million, is that a level we should look at for Q2 as well?

Scott Longval: No, I think, if you - Dick, if you heard the numbers that Mark highlighted on the backlog perspective, we think and we envision that, that revenue number for the second quarter will be a little bit higher than the first quarter.

Dick Ryan: Okay. Has the digital hearing aids been introduced in that channel yet?

(Crosstalk)

Mark Gorder: Yes. There was - one digital hearing aid has just been introduced to HHE.

Dick Ryan: Okay. And what's been the delay there to wrap up the remaining 80%?

Scott Longval: We're working right now with our bank to understand the best way to finance that transaction that gives us enough flexibility to provide the level of advertising that we want to provide. So just looking for the most flexible option.

Dick Ryan: Okay, okay. You know, listening to the FTC workshop last week, I mean, obviously, when you combine that with the FDA and the legislation, everything does seem to be moving your way.

You know, other than the blocking and tackling you talked about, higher level, is there any other things that you need to be doing or need to be working with to maybe help kick that door open a little further or faster?

Mark Gorder: Well, I think, the - there's definitely a very strong consumer and political outcry for reform in the channel. And we participated in the - during the week of March 13, because Delain Wright, our VP of Business Development, myself, were actually out in DC, working.

We actually visited Senator Warren's office and participated in the discussion of the language that was going in there, which we strongly support. And we get the opinion there that the political process is very much in favor of this and it's getting broad support.

Now, you know, with legislation, you never know, but they're anticipating that something may happen as early as the fall. There's not much more we can do other than continue - we continue to reach out to the various members of the Senate and the House that are supporting this and let them know that there are manufacturers like IntriCon that, as opposed to the Big 6, are clearly supporting this legislation.

So I don't think there's too much more we can do other than that, Dick, but we are actively engaged in doing what we can.

Dick Ryan: Okay. Yes, because I was just wondering - you just get a few more agencies or whatever to pile on, and then it just becomes this bureaucratic mess where maybe nothing moves that quickly. Independently, is there anything you can do outside the policies or regulations?

Mark Gorder: Nothing that comes to mind other than continuing to communicate our support. And by creating some of the technology infrastructure that we are building within IntriCon to support HHE and building out our ecosystem of care, we took the position with the - with Senator Warren's office, that a lot of these things are already being done.

And they can clearly be done better and faster if they can get this regulatory obstacle out of our way. And so we continue to - I think, we can continue to develop the technology and push our message out, but I don't think there's much more we can do beyond that.

Dick Ryan: Okay, great. Thank you, guys. Congratulations.

Male: Okay, thanks, Dick.

Operator: We'll take our next question from Scott Billeadeau with Walrus Partners. Please go ahead.

Your line is open.

Scott Billeadeau: Oh, hey, guys. Just a couple of questions here. With the HHE, you mentioned \$1.4 million. Is that 100% of their sales given you only own 20%? Are you just reporting all of their sales? And then also, are you taking all of their expenses? Or will - maybe just walk through that for me, if you could.

Scott Longval: So right now, the \$1.4 million represents 100% of their sales. Now while we only own 20%, we are really the managing company of that business. And because of that, (gap) forces us to consolidate that business into our numbers.

Scott Billeadeau: Okay.

Scott Longval: So the \$1.4 million again represents all their sales. And if you look down to the bottom of the P&L, you'll see an allocation out for the percentage of gain or loss that gets allocated back to the 80% share hurdle. So we're only recognizing 20% of the bottom line impact.

Scott Billeadeau: Right, which is a loss. So you'll be bringing those losses in, is that, right? I mean, is that - so that business - because I think you backed out, what, something like \$400,000, I forget the number off the top of my head, roughly.

Scott Longval: Yes.

Scott Billeadeau: Roughly...

Scott Longval: So that will still be determined on how that's going to be handled, but one of the likely outcomes could be us having to bring that back in at some point.

Scott Billeadeau: Yes, yes. Okay, and then with Soundperience, is there - you know, what kind of - I mean, is that a - is there a significant loss there? What's that business look at as - I'm just kind of trying to figure out as we, quote, unquote, say, you know, "two quarters down or three quarters down," when all of this - when you actually own 49% of that and you got HHE all in. I'm just - - you know, what - how much do you expect that to add to the expenses at that point?

Mark Gorder: Scott, I think the short answer to that is Soundperience is a relatively small service business in the German market. Their revenue is very low. I'm not sure the exact number off the top of my head, but this is primarily a technology play for us.

What - I had met this gentleman back in 2011, and we had a couple of initiatives going to try to acquire a position in self-fitting technology, and one of those options got bought by Bose Corporation.

And so the remaining - the next remaining viable candidate was Soundperience. And so we were very interested in getting a position in self-fitting technology, so we've been working on this for some time.

And we see it mainly as an opportunity to develop this technology, bring it into the US market and support building out the infrastructure for our envisioned ecosystem of care in the value-based hearing health space. And Scott may have some additional insight into what the financial impact is.

Scott Longval: So we'll be acquiring that and they'll be reported on the equity method of accounting, so there will be no revenue or loss - or excuse me, no revenue or operating expenses flowing through our statements.

It'll simply be a one line item on our P&L with the gain or loss from Soundperience. And from what I can tell you, it's essentially a breakeven business. So...

Scott Billeadeau: And for you guys, the key was to get that - the US license to use that. That was the key. Yes? Okay.

Scott Longval: Correct. Along with some first right of refusals and protecting a very valuable asset that's going to be critical for building this ecosystem of care.

Scott Billeadeau: Okay. Just another question on your revenue guidance, you know, you've got \$20 million and roughly 20 - you put up \$20 million, you're going to put \$20 million in the next quarter.

You kind of guided \$79 million to \$81 million, so that suggests second half flat with first half. I think you mentioned you may see some - you know, with your large medical customer, was there a little bit of fill upfront?

So is that the issue? I'm just trying to figure out how that math - because it kind of suggests there's no sequential growth here for a little bit.

Scott Longval: I think, you know, if we talk about the large customer, I think, you know, Mark that we're envisioning seeing continued growth. And if you look at that range, we did up the range from where we previously announced it last quarter.

We believe that we can be at the high end of the range of that number. But, you know, at this point, we wanted to take maybe a little bit more of a conservative approach and see how things play out as we're not necessarily in control of Medtronic's launch cycles.

But I guess today, as we sit here, we think based on the information, we could definitely hit the top end of that range.

Scott Billeadeau: Great. Thanks. And then just one last quick question on - certainly, it sounds really interesting to have the self-fitting and particularly if, you know, someone doesn't have to be tethered to a PC.

Maybe just kind of in my head, I'm trying to, you know, understand the wireless self-fitting. Would that be an instance where, you know, HHE can ship them out, that person can either log onto a computer, and, you know, do you talk, you know, WiFi or Bluetooth to the headsets and go through a fitting process? Is that - am I kind of in the right range of what the thought process...

Mark Gorder: You're the right range, Scott. You're in the right range. I would characterize it as probably the initial embodiment would be to send out - in fact, the way it's being piloted in Germany, they're actually doing a professionally managed self-fitting where they bring them into the shop.

They sit the patient down at an iPad, which Soundperience provides, and then that patient walks through it on their own. And then the professionals there kind of oversee it.

But what we envision that transitioning is eventually that wired link gets removed and it'll be a low-energy Bluetooth connection between the hearing aids and the smart device.

And then we could send - either the patient would have a smart device and download an app or we would send them a smart device and then they would use that BLE connection to walk through the process defined by the app and self-fit the device. So you were right on as to how you described it.

Scott Billeadeau: (Very good). Okay. Okay, great. That's all I have. Thanks, guys.

Male: Thank you, Scott.

Operator: As a reminder, to ask a question on today's call, please press the star and one on your touch-tone telephone keypad. Once again, if you'd like to ask a question today, please press star and one now. We'll take our next question from Larry Haimovitch with HMC - HMTC, excuse me. Your line is open. Please go ahead.

Larry Haimovitch: Good afternoon, gentlemen.

Male: Good afternoon, Larry.

Larry Haimovitch: A couple of questions on the hearing aid business. Number one, on an apples-to-apples basis, so the same-store sales, what was the growth in that business in Q1? In other words, taking up the increment from HHE, did that business grow on a same-store basis?

Mark Gorder: When you look at hearing health, you've got to break it into our traditional business and our new emerging value-based business. The traditional business is declining, as we've said in the past, because of the consolidation by the big guys.

And so if you take that business aside, the value-based business is growing because we've got, in that category, United Healthcare, some of the stuff we're doing in the UK.

HHE will now fall into that category. So that part of the business is on the upturn. And I think we're nearing the end of the downturn from the traditional business.

We've got very little business left with the big guys. I think it's - the Big 6 manufacturers is only about \$1.5 million of revenue left in that category in 2017.

And then we'll have a lot of legacy business with some of our Chinese customers and small US customers and other global customers. Does that kind of answer that?

Larry Haimovitch: Yes. And PC Werth, the UK business, it looks very promising. You're making some real headway in terms of approvals with the National Health Service. How are revenues trending?

I know it's a bit of a bump when you first acquired it, getting integrated, maybe some people issues, whatever. Do you see that business - has it grown in the past couple of quarters? And what do you foresee for that particular segment of the hearing aid business at this point, Mark?

Mark Gorder: When we took on PCW initially, it was kind of a distressed business. We had hoped, as we've said in the past, that we could maintain it as a distributor. But when it ran into issues, we figured we wanted to defend our position with the NHS so we took it on.

And initially, they had, I think, a pretty good first quarter, but once the Big 6 manufacturers who were providing some product lines in the PCW for distribution, they pulled those away from us.

And we had to sort of stabilize the business, which we did in Q2 of last year of 2016. Scott, relative to growth quarter-over-quarter, I'm not sure what the percent was.

Scott Longval: Yes, so we saw growth, Larry, from Q3 to Q4. We saw growth again here from Q4 into Q1.

Larry Haimovitch: Okay.

Scott Longval: I think if you look going forward, where we really need to drive growth is in the hearing aids. So we've laid out a strategy that we want to be a supplier to the largest consumer of hearing aids in the world, which is the NHS.

Larry Haimovitch: Yes. Right.

Scott Longval: And we have the technology to do it. And what we need to do is make more inroads on the hearing aid front. We think the approval yesterday is a significant step forward.

We think the device has a wide-fitting range. This is something that, now, we're going to take into the targeted clinics as Mark laid out. We'll be reporting on our progress with this device into those clinics at the end of the second quarter and continue to keep you guys informed and have the transparency into our progress, because that is our number one with PC Werth.

Mark Gorder: So I guess we'll continue to update shareholders as to our success in getting into those clinics.

Larry Haimovitch: Approximately what's the annualized run rate for PCW right now?

Scott Longval: Right now, the annual run rate is about \$4.5 million.

Larry Haimovitch: And that's about what it was when you acquired it, wasn't that right?

Scott Longval: Correct. And we've kind of seen the revenue go down in the immediate - immediately when the Big 6 pulled back and we've built some of that up. But again, kind of the long-term approach and viability of that business, we have to be selling hearing aids.

Larry Haimovitch: Yes.

Scott Longval: And so we feel like we've put our best foot forward now, and it's now getting into those clinics and convincing them that our products can meet the needs of their consumers.

Larry Haimovitch: Scott, who calls on those clinics? Are they direct IntriCon PCW employees? Or are they distributors that carry other product line?

Mark Gorder: Direct IntriCon employees that have some audiological experience and good knowledge of the NHS and how it works.

Scott Longval: And to that point, we talked a little bit about how we restructured that business and put more focus on sales people within the NHS. We hired an individual that formerly worked at the NHS as an audiologist.

So that gentleman has a very good understanding of the inner workings of the NHS ((inaudible)) and how to navigate some of those landmines. So again, we feel like we've taken the steps to put ourselves in position to be successful. And now, really the focus over the next couple of quarters is execution.

Larry Haimovitch: Okay. And then one more question on the whole hearing aid business, then I'll jump back in the queue. And that is I know you were looking for someone to really run that business. You made some progress.

I think you may have brought somebody on as a consultant. Bring us up to date on the leadership in that business that's focused specifically on that business aside from you guys who have, obviously, have other responsibilities as well.

Mark Gorder: Well, we - as we said, Larry, IntriCon is an OEM manufacturer. We aren't a direct-to-consumer company, so we knew we had to bring talent on board to run and integrate with us and grow that business.

So we hired - initially went on a search for a consultant to run it in the interim term. And it turns out that that gentleman was very qualified in direct-to-consumer, running direct-to-consumer businesses and digital marketing. And we're in the process of seeing if that position could be made, not a temporary position, but a permanent position.

Larry Haimovitch: Got you.

Mark Gorder: And the gentleman who runs it, (Jim) - his name is (Jim Houlihan). He will be at our annual meeting on Thursday. And he has also brought on a very talented Director of Marketing, who has put digital marketing systems into a couple of businesses prior to HHE.

And between the two of them, they are in the process of analyzing our strategy for marketing into that business, and we're trying to figure out what the right mix is to optimize driving growth in that business. So we - that's where we're at with the management structure.

Larry Haimovitch: Okay, (beautiful). Hey, thanks very much, guys.

Mark Gorder: Thanks, Larry.

Operator: Once again, to ask a question on today's call, please press the star and one on your telephone keypad. And we will pause a moment to allow any further questions to queue. And there are no further questions at this time. So I'll return the call to your Chief Executive Officer, Mr. Mark Gorder.

Mark Gorder: Thank you, operator. Once again, we appreciate you taking time out of your day to join the call. In closing, I'd like to reiterate that I am very excited with the direction we are headed.

We're encouraged by our start to 2017. Sales are ramping as expected, and we have the infrastructure in place to deliver long-term growth. Moreover, we're excited about creating and cultivating a new channel to deliver superior outcomes-based, affordable hearing health care directly to consumers.

We look forward to sharing our successes with you in the future and thank you again for joining the call. And as I mentioned earlier, if you're at the annual meeting, you'll be able to see a very nice presentation of our self-fitting technology. So thank you, everyone.

Operator: This does conclude today's program. Thank you for your participation and you may disconnect at any time.

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